

AUDITING PROCEDURES REPORT

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Local Government Type <input type="checkbox"/> City <input type="checkbox"/> Township <input type="checkbox"/> Village <input checked="" type="checkbox"/> Other		Local Government Name Michigan South Central Power Agency	County Hillsdale
Audit Date June 30, 2006	Opinion Date August 10, 2006	Date Accountant Report Submitted to State: September 15, 2006	

We have audited the financial statements of this local unit of government and rendered an opinion on financial statements prepared in accordance with the Statements of the Governmental Accounting Standards Board (GASB) and the *Uniform Reporting Format for Financial Statements for Counties and Local Units of Government in Michigan* by the Michigan Department of Treasury.

We affirm that:

1. We have complied with the *Bulletin for the Audits of Local Units of Government in Michigan* as revised.
2. We are certified public accountants registered to practice in Michigan.

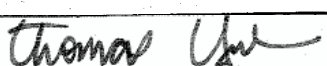
We further affirm the following. "Yes" responses have been disclosed in the financial statements, including the notes, or in the report of comments and recommendations

You must check the applicable box for each item below.

- ☐ yes ☒ no 1. Certain component units/funds/agencies of the local unit are excluded from the financial statements.
- ☐ yes ☒ no 2. There are accumulated deficits in one or more of this unit's unreserved fund balances/retained earnings (P.A. 275 of 1980).
- ☐ yes ☒ no 3. There are instances of non-compliance with the Uniform Accounting and Budgeting Act (P.A. 2 of 1968, as amended).
- ☐ yes ☒ no 4. The local unit has violated the conditions of either an order issued under the Municipal Finance Act or its requirements, or an order issued under the Emergency Municipal Loan Act.
- ☐ yes ☒ no 5. The local unit holds deposits/investments which do not comply with statutory requirements. (P.A. 20 of 1943, as amended [MCL 129.91], or P.A. 55 of 1982, as amended [MCL 38.1132]).
- ☐ yes ☒ no 6. The local unit has been delinquent in distributing tax revenues that were collected for another taxing unit.
- ☐ yes ☒ no 7. The local unit has violated the Constitutional requirement (Article 9, Section 24) to fund current year earned pension benefits (normal costs) in the current year. If the plan is more than 100% funded and the overfunding credits are more than the normal cost requirement, no contributions are due (paid during the year).
- ☐ yes ☒ no 8. The local unit uses credit cards and has not adopted an applicable policy as required by P.A. 266 of 1995 (MCL 129.241).
- ☐ yes ☒ no 9. The local unit has not adopted an investment policy as required by P.A. 196 of 1997 (MCL 129.95).

We have enclosed the following:

	Enclosed	To Be Forwarded	Not Required
The letter of comments and recommendations.			X
Reports on individual federal financial assistance programs (program audits).			X
Single Audit Reports (ASLGU).			X

Certified Public Accountant (Firm Name) Virchow, Krause & Company, LLP			
Street Address 10 Terrace Court	City Madison	State WI	ZIP 53707
Accountant Signature 			

**MICHIGAN SOUTH CENTRAL
POWER AGENCY**
Litchfield, Michigan

FINANCIAL STATEMENTS

June 30, 2006 and 2005

MICHIGAN SOUTH CENTRAL POWER AGENCY

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INDEPENDENT AUDITORS' REPORT

To the Board of Commissioners
Michigan South Central Power Agency
Litchfield, Michigan

We have audited the accompanying financial statements as listed in the table of contents, of the Michigan South Central Power Agency as of June 30, 2006 and 2005, and for the years then ended. These financial statements are the responsibility of the Agency's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Michigan South Central Power Agency as of June 30, 2006 and 2005, and the results of its operations and its cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

As described in Note 16 to the financial statements, the Agency has changed its method of accounting for accrued interest on member rate stabilization balances in fiscal 2006.

The Management's Discussion and Analysis on pages 2 through 7 is not a required part of the basic financial statements, but is supplementary information required by the Governmental Accounting Standards Board. We have applied certain limited procedures that consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit the information and express no opinion on it.

Virchow, Krause & Company, LLP

Madison, Wisconsin
August 10, 2006

MANAGEMENT'S DISCUSSION AND ANALYSIS

MICHIGAN SOUTH CENTRAL POWER AGENCY

MANAGEMENT'S DISCUSSION AND ANALYSIS June 30, 2006 and 2005

The management of the Michigan South Central Power Agency (the "Agency") offers all persons interested in the Agency's financial position this narrative overview and analysis of the Agency's financial performance during the years ending June 30, 2006 and 2005. Please read this narrative in conjunction with the accompanying financial statements and the accompanying notes to financial statements.

OVERVIEW OF THE FINANCIAL STATEMENTS

Michigan South Central Power Agency is a public body politic and corporate of the State of Michigan. The Agency was organized on March 21, 1978, under the authority of Michigan Public Act 448 of 1976, to supply electricity to member municipalities in south central Michigan. The Agency has five members: the Cities of Coldwater, Hillsdale, and Marshall; and the Villages of Clinton and Union City.

This annual report consists of two parts: Management's Discussion and Analysis (this section) and the basic financial statements. These statements are prepared on the accrual basis of accounting in accordance with accounting principals generally accepted in the United States of America. The Agency uses the Uniform System of Accounts prescribed by the Federal Energy Regulatory Commission.

The Balance Sheet reports year end assets, liabilities and net asset balances based on the original cost adjusted for any depreciation, amortization or unrealized gains/losses as appropriate. The Statement of Revenues, Expenses and Changes in Net Assets presents information showing how the Agency's net assets changed due to the Agency's business activity. The Statement of Cash Flows reports the cash provided and used for operating activities, as well as other cash sources such as investment income and cash payments for repayment of bonds and capital additions.

AGENCY FINANCIAL ANALYSIS

Fiscal year 2006 was a busy year, operationally and financially. This year marked the first full year of Agency operations as a "Market Participant" in the Midwest Independent System Operator (MISO) Midwest Market Initiative energy market. This market, which commenced on April 1st, 2005, is meant to coordinate the provision of reliable, cost-effective energy. In 2006 and 2005, the Agency incurred approximately \$1,835,000 and \$350,000, respectively, in MISO market charges. These amounts include a total of approximately \$1,026,000 and \$137,000, respectively, in "Revenue Sufficiency Guarantee" charges – a portion of which is subject to refund based on a recent Federal Energy Regulatory Commission ruling. An exact amount is not known at this time. An additional \$811,818 and \$183,214, respectively, was spent on "Seams Elimination Cost Adjustment" expenses, which directly relates to the MISO market.

Late in fiscal year 2004, the Agency began a relationship with American Municipal Power of Ohio (AMP-Ohio) in order to facilitate the Agency's MISO market participation. For an approximate \$220,000 annual fee, the Agency is able to use the services of AMP-Ohio's energy control center. This arrangement allows the Agency to avoid creating and staffing its own control center. This relationship has broadened to include a bilateral sales agreement, and the acceptance of the Agency's members as full AMP-Ohio members in July of 2006.

MICHIGAN SOUTH CENTRAL POWER AGENCY

MANAGEMENT'S DISCUSSION AND ANALYSIS (cont.) June 30, 2006 and 2005

AGENCY FINANCIAL ANALYSIS (cont.)

The Agency is continuing to reap the benefits of two bond transactions which were completed in fiscal year 2005. In late October 2004, a seven percent fixed rate bond was replaced by a variable rate note. This transaction has yielded savings of approximately \$530,000 through fiscal year 2006. Although there is no guarantee that variable rates will remain low, the relatively short maturity of the debt (due in 2011) and relatively small size of the issue (\$9.2 million) hedge the risk somewhat. This savings is in addition to the \$120,000 in total savings due to the October 2004 defeasance of approximately \$1,060,000 in principal and interest payments on other outstanding debt.

Two key employees retired in fiscal year 2006. The Agency thanks Mr. John Novak, Power Production Superintendent, and Mr. J.P. Bierl, the Agency's General Manager, for their dedication and wishes them an enjoyable retirement. With the retirements, the Board of Commissioners put its existing succession plan into action. Mr. James Balbo was promoted to Power Production Superintendent; Mr. Glen White, previously the Assistant General Manager, was appointed to General Manager effective July 1, 2006.

An analysis of the Agency's financial position begins with the review of the Balance Sheet, the Statement of Revenues, Expenses and Changes in Net Assets and the Statement of Cash Flows report information. A summary of the Agency's Balance Sheet is presented in Table 1. The Statement of Revenues, Expenses and Changes in Net Assets are summarized in Table 2 and Table 3 presents a summary of the Statement of Cash Flows.

Table 1
Condensed Balance Sheet

	2006	2005	2004
Current assets	\$ 9,084,562	\$ 12,589,923	\$ 13,783,360
Restricted assets	18,814,631	18,237,726	18,992,113
Other assets	12,005,485	13,955,099	14,592,042
Utility plant	36,336,950	37,047,414	37,741,846
Total Assets	<u>76,241,628</u>	<u>81,830,162</u>	<u>85,109,361</u>
Non-current liabilities	46,795,374	53,901,310	60,704,761
Current liabilities	11,941,487	12,705,271	11,838,488
Total Liabilities	<u>58,736,861</u>	<u>66,606,581</u>	<u>72,543,249</u>
Net Assets			
Invested in capital assets, net of related debt	(16,911,477)	(22,474,513)	(28,330,635)
Restricted	18,381,657	17,746,642	18,346,996
Unrestricted	16,034,587	19,951,452	22,549,751
Total Net Assets	<u>17,504,767</u>	<u>15,223,581</u>	<u>12,566,112</u>
Total Net Assets and Liabilities	<u>\$ 76,241,628</u>	<u>\$ 81,830,162</u>	<u>\$ 85,109,361</u>

MICHIGAN SOUTH CENTRAL POWER AGENCY

MANAGEMENT'S DISCUSSION AND ANALYSIS (cont.) June 30, 2006 and 2005

AGENCY FINANCIAL ANALYSIS (cont.)

Table 2
Condensed Statement of Revenues, Expenses and Changes in Net Assets

	<u>2006</u>	<u>2005</u>	<u>2004</u>
Operating revenues	\$ 44,961,391	\$ 38,634,773	\$ 36,757,645
Depreciation expense	2,999,543	2,987,185	2,991,381
Other operating expenses	<u>34,276,073</u>	<u>27,981,056</u>	<u>25,950,361</u>
Total Operating Expenses	<u>37,275,616</u>	<u>30,968,241</u>	<u>28,941,742</u>
Operating income	<u>7,685,775</u>	<u>7,666,532</u>	<u>7,815,903</u>
Investment and miscellaneous income	784,118	932,610	973,355
Interest and amortization expense	(3,830,787)	(4,557,764)	(5,044,406)
Other income (expense)	<u>11,432</u>	<u>(1,383,909)</u>	<u>(3,681,913)</u>
Total Non-Operating Expenses	<u>(3,035,237)</u>	<u>(5,009,063)</u>	<u>(7,752,964)</u>
Income Before Cumulative Effect of Change in Accounting Principle	4,650,538	2,657,469	62,939
Cumulative effect of change in accounting principle	<u>(2,369,352)</u>	<u>-</u>	<u>-</u>
Change in Net Assets	2,281,186	2,657,469	62,939
NET ASSETS – Beginning of Year	<u>15,223,581</u>	<u>12,566,112</u>	<u>12,503,173</u>
NET ASSETS – END OF YEAR	<u>\$ 17,504,767</u>	<u>\$ 15,223,581</u>	<u>\$ 12,566,112</u>

MICHIGAN SOUTH CENTRAL POWER AGENCY

MANAGEMENT'S DISCUSSION AND ANALYSIS (cont.) June 30, 2006 and 2005

AGENCY FINANCIAL ANALYSIS (cont.)

Table 3
Condensed Statement of Cash Flows

	2006	2005	2004
Received from power sales	\$ 45,158,951	\$ 36,891,974	\$ 32,988,658
Paid to suppliers for purchased power and transmission	(31,426,615)	(22,388,808)	(18,600,973)
Paid to suppliers and employees for other services	(3,748,825)	(3,627,843)	(3,520,288)
Cash Flows from Operating Activities	<u>9,983,511</u>	<u>10,875,323</u>	<u>10,867,397</u>
Deferred rate stabilization withdraw	(3,500,000)	-	-
Cash Flows from Noncapital Financing Activities	<u>(3,500,000)</u>	<u>-</u>	<u>-</u>
Debt principal and interest paid	(10,162,399)	(19,791,550)	(10,590,141)
Net debt issuance costs, proceeds and defeasance costs	-	8,529,181	2,198,410
Net acquisition, disposal, and cash contribution for capital assets	<u>(2,277,647)</u>	<u>(2,463,223)</u>	<u>(3,378,764)</u>
Cash Flows from Capital and Related Financing Activities	<u>(12,440,046)</u>	<u>(13,725,592)</u>	<u>(11,770,495)</u>
Cash Flows from Investing Activities	<u>4,746,923</u>	<u>3,336,958</u>	<u>4,282,545</u>
Net Change in Cash and Cash Equivalents	(1,209,612)	486,689	3,379,447
CASH AND CASH EQUIVALENTS - Beginning of Year	<u>10,479,780</u>	<u>9,993,091</u>	<u>6,613,644</u>
CASH AND CASH EQUIVALENTS - ENDING OF YEAR	<u><u>\$ 9,270,168</u></u>	<u><u>\$ 10,479,780</u></u>	<u><u>\$ 9,993,091</u></u>

BALANCE SHEET

Combined together, "Current assets" plus "Other assets" decreased by \$5.4 million during fiscal year 2006. This reduction is due to two large transactions; one, a \$3.5 million cash withdrawal from the Rate Stabilization Fund by the City of Coldwater; and two, the funding of capital projects. Detailed discussion of the Rate Stabilization Fund transaction and a related change in accounting treatment may be found in the Footnotes to the Financial Statements under "Deferred Rate Stabilization."

MICHIGAN SOUTH CENTRAL POWER AGENCY

MANAGEMENT'S DISCUSSION AND ANALYSIS (cont.)

June 30, 2006 and 2005

BALANCE SHEET (cont.)

The Agency's commitment to maintaining and improving the Plant in order to provide reliable, value-based electricity to its members is reflected in the stability of the Utility Plant balance. As was the case in fiscal 2005, the relatively small change in fiscal 2006's Utility Plant number is the net effect of two larger transactions. In February of 2006, the Agency purchased 31.5 MW of EHV transmission lines from METC. This \$1.881 million, internally-funded transaction, combined with other additions which totaled approximately \$400,000, offset a large portion of the approximately \$3 million in normal depreciation costs. Last year, the largest addition was a \$2.2 million replacement cooling tower.

As was the case in fiscal year 2005, the Agency continues to reap the benefits of debt service payments that are aggressively reducing principal instead of just covering interest requirements. The reduction in Total Liabilities reflects this fact.

STATEMENT OF REVENUES, EXPENSES AND CHANGES IN NET ASSETS

Both operating revenues and expenses increased by larger amounts (16.4 and 20.4 percent, respectively) than in years past. These increases are a result of the first full year of operations with the power sales contract with AMP-Ohio, under the MISO market, and dealing with increased fuel costs. The power sales to AMP-Ohio allow us to operate the Endicott Generating Station at a more consistent level, which leads to more efficient operations. The similar outcome in Operating Income for fiscal year 2006 and 2005 is tied to the Agency's need to meet bond covenants.

The marked change in "Other income (expense)" over the last three years reflects the fact that previously-deferred depreciation expense had been fully recognized midway through fiscal year 2005. Further detail may be found in the Footnotes to the Financial Statements titled "Net Deferred Costs Recoverable in Future Years." The large change in Income is attributed to debt service needs – although cash is collected from members and recorded as revenue, the associated debt payment (of principal) is recorded as a balance sheet item.

The "Cumulative effect of change in accounting principle" reclassifies data previously found in a Footnote to the Financial Statements ("Deferred Rate Stabilization") to a component of Net Assets. The Agency believes that this accounting change creates a more user-friendly financial statement. Further information may be found in the previously-mentioned Footnote.

STATEMENT OF CASH FLOWS

"Cash and cash equivalents" are defined as investments which mature in 90 days or less, plus immediately accessible bank accounts. In fiscal year 2006, two large cash transactions stand out from regularly-recurring Agency operations – the withdrawal of \$3,500,000 in Rate Stabilization Funds by the City of Coldwater, and the \$1.881 million transmission line purchase. Both transactions were planned and consummated in an orderly fashion.

MICHIGAN SOUTH CENTRAL POWER AGENCY

MANAGEMENT'S DISCUSSION AND ANALYSIS (cont.) June 30, 2006 and 2005

DEBT SERVICE COVERAGE

The Agency's bond documents require the Agency to maintain certain restrictive financial covenants, the most restrictive being the requirement that net revenues must equal at least 110% of the aggregate bond service for the year. The Agency fully met or exceeded all bond covenants for the years ended June 30, 2006 and 2005. Further details can be found in the Footnotes to the Financial Statements, under "Aggregate Bond Service Coverage."

CONTACTING AGENCY MANAGEMENT

This financial report is designed to provide our members, investors, and creditors with a general overview of Michigan South Central Power Agency's finances. Questions concerning any of the information provided in this report or requests for additional information should be addressed to Michigan South Central Power Agency, 720 Herring Rd., Litchfield, MI 49252.

Balance Sheets Follow

MICHIGAN SOUTH CENTRAL POWER AGENCY

BALANCE SHEETS June 30, 2006 and 2005

ASSETS			2006	2005
CURRENT ASSETS				
Unrestricted cash and cash equivalents	\$	1,918,261	\$	6,847,129
Restricted cash and investments		8,257,626		6,000,455
Unrestricted investments		1,139,843		349,303
Accounts receivable		3,749,884		3,868,309
Interest receivable		230,037		215,006
Inventory		1,650,131		893,502
Prepayments and other current assets		396,406		416,674
Total Current Assets		<u>17,342,188</u>		<u>18,590,378</u>
NON-CURRENT ASSETS				
Other Non-Current Assets				
Restricted investments		10,557,005		12,237,271
Unrestricted investments		9,167,392		10,793,416
Debt issue costs		1,340,730		1,646,321
Emissions credits		563,320		708,500
Deferred maintenance costs		171,719		471,719
Deferred costs recoverable in future years		762,324		335,143
Total Other Non-Current Assets		<u>22,562,490</u>		<u>26,192,370</u>
Capital Assets				
Utility plant (including construction work in progress)		95,333,008		93,218,852
Accumulated depreciation		<u>(58,996,058)</u>		<u>(56,171,438)</u>
Total Utility Plant		<u>36,336,950</u>		<u>37,047,414</u>
TOTAL ASSETS	\$	<u>76,241,628</u>	\$	<u>81,830,162</u>

NET ASSETS AND LIABILITIES		
	<u>2006</u>	<u>2005</u>
CURRENT LIABILITIES		
Accounts payable and accrued expenses		
Accounts payable	\$ 1,936,685	\$ 2,144,996
Compensation and related amounts	551,252	523,947
Deferred rate stabilization	1,226,793	2,278,306
Total Accounts Payable and Accrued Expenses	<u>3,714,730</u>	<u>4,947,249</u>
Current liabilities payable from restricted assets		
Current portion of long-term debt	7,793,783	7,266,938
Accrued interest payable	432,974	491,084
Total Current Liabilities Payable from Restricted Assets	<u>8,226,757</u>	<u>7,758,022</u>
Total Current Liabilities	<u>11,941,487</u>	<u>12,705,271</u>
NON-CURRENT LIABILITIES		
Long-term debt, net of discounts, premiums and losses	<u>46,795,374</u>	<u>53,901,310</u>
Total Liabilities	<u>58,736,861</u>	<u>66,606,581</u>
NET ASSETS		
Invested in capital assets, net of related debt	(16,911,477)	(22,474,513)
Restricted for debt service	18,381,657	17,746,642
Unrestricted	16,034,587	19,951,452
Total Net Assets	<u>17,504,767</u>	<u>15,223,581</u>
TOTAL NET ASSETS AND LIABILITIES	<u>\$ 76,241,628</u>	<u>\$ 81,830,162</u>

See accompanying notes to financial statements and independent auditors' report.

MICHIGAN SOUTH CENTRAL POWER AGENCY

STATEMENTS OF REVENUES, EXPENSES AND CHANGES IN NET ASSETS

Years Ended June 30, 2006 and 2005

	<u>2006</u>	<u>2005</u>
OPERATING REVENUES		
Sales to Members	\$ 42,365,877	\$ 37,912,099
Other Sales	<u>2,595,514</u>	<u>722,674</u>
Total Operating Revenues	<u>44,961,391</u>	<u>38,634,773</u>
OPERATING EXPENSES		
Operations	29,747,444	23,961,927
Maintenance	2,480,632	2,117,944
Administration and general	2,047,997	1,901,185
Depreciation	<u>2,999,543</u>	<u>2,987,185</u>
Total Operating Expenses	<u>37,275,616</u>	<u>30,968,241</u>
Operating Income	<u>7,685,775</u>	<u>7,666,532</u>
NON-OPERATING REVENUE (EXPENSES)		
Investment and miscellaneous income	1,271,640	1,107,040
Net decrease in the fair value of investments	(487,522)	(174,430)
Interest expense on long-term debt	(2,837,349)	(3,341,969)
Gain (loss) on disposal of assets	11,432	(170,470)
Amortization of debt costs, discounts, premiums and losses	(993,438)	(1,215,795)
Net change in deferred costs excluding capital contributions and extraordinary item	<u>-</u>	<u>(1,213,439)</u>
Total Non-Operating Expenses	<u>(3,035,237)</u>	<u>(5,009,063)</u>
Income Before Cumulative Effect of Change in Accounting Principle	4,650,538	2,657,469
Cumulative effect of change in accounting principle	<u>(2,369,352)</u>	<u>-</u>
Change in Net Assets	2,281,186	2,657,469
NET ASSETS - Beginning of Year	<u>15,223,581</u>	<u>12,566,112</u>
NET ASSETS - END OF YEAR	<u>\$ 17,504,767</u>	<u>\$ 15,223,581</u>

See accompanying notes to financial statements and independent auditors' report.

Statements of Cash Flows Follow

MICHIGAN SOUTH CENTRAL POWER AGENCY

STATEMENTS OF CASH FLOWS Years Ended June 30, 2006 and 2005

	2006	2005
CASH FLOWS FROM OPERATING ACTIVITIES		
Received from sales to members and others	\$ 45,158,951	\$ 36,891,974
Paid to suppliers for goods and services	(31,426,615)	(22,388,808)
Paid to employees for services	(3,748,825)	(3,627,843)
Net Cash Flows from Operating Activities	<u>9,983,511</u>	<u>10,875,323</u>
CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES		
Deferred rate stabilization withdraw	(3,500,000)	-
Net Cash Flows from Noncapital Financing Activities	<u>(3,500,000)</u>	<u>-</u>
CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES		
Capital expenditures for utility plant	(2,297,097)	(2,463,223)
Proceeds from sale of utility plant	19,450	-
Debt issuance costs	-	(392,975)
Proceeds from issuance of new debt	-	9,200,000
Principal payments on long-term debt	(7,266,940)	(16,295,548)
Call premium on old debt	-	(167,700)
Early defeasance of debt	-	(110,144)
Interest payments on long-term debt	(2,895,459)	(3,496,002)
Cash Flows From Capital and Related Financing Activities	<u>(12,440,046)</u>	<u>(13,725,592)</u>
CASH FLOWS FROM INVESTING ACTIVITIES		
Proceeds from sales and maturities of investments	6,683,074	20,390,889
Purchases of investments	(3,102,876)	(17,966,753)
Interest received	1,166,725	912,822
Cash Flows from Investing Activities	<u>4,746,923</u>	<u>3,336,958</u>
Net Change in Cash and Cash Equivalents	(1,209,612)	486,689
CASH AND CASH EQUIVALENTS – Beginning of Year	<u>10,479,780</u>	<u>9,993,091</u>
CASH AND CASH EQUIVALENTS – END OF YEAR	<u>\$ 9,270,168</u>	<u>\$ 10,479,780</u>
NONCASH INVESTING ACTIVITY		
Unrealized gains (losses) on investments	<u>\$ (396,636)</u>	<u>\$ (1,033)</u>

	2006	2005
RECONCILIATION OF OPERATING INCOME TO NET CASH FLOWS FROM OPERATING ACTIVITIES		
Operating income	\$ 7,685,775	\$ 7,666,532
Noncash Items Included in Operating Income		
Depreciation	2,999,543	2,987,185
Deferred maintenance	300,000	300,000
Changes in assets and liabilities		
Accounts receivable	118,425	(553,921)
Inventory	(756,629)	(68,987)
Emissions credits	145,180	47,500
Deferred costs	(427,181)	(335,143)
Prepayments	20,268	(12,268)
Accounts payable	(208,310)	792,785
Compensation and related amounts	27,305	27,079
Deferred rate stabilization	79,135	24,561
NET CASH FLOWS FROM OPERATING ACTIVITIES	\$ 9,983,511	\$ 10,875,323
RECONCILIATION OF CASH AND CASH EQUIVALENTS TO THE BALANCE SHEET		
Restricted cash and investments - current	\$ 8,257,626	\$ 6,000,455
Unrestricted investments - current	1,139,843	349,303
Restricted investments - non-current	10,557,005	12,237,271
Unrestricted investments - non-current	9,167,392	10,793,416
Unrestricted cash and cash equivalents	1,918,261	6,847,129
Total Cash and Investments	31,040,127	36,227,574
Less: Long-Term Investments	(21,769,959)	(25,747,794)
TOTAL CASH AND CASH EQUIVALENTS	\$ 9,270,168	\$ 10,479,780

See accompanying notes to financial statements and independent auditors' report.

MICHIGAN SOUTH CENTRAL POWER AGENCY

NOTES TO FINANCIAL STATEMENTS

June 30, 2006 and 2005

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES AND NATURE OF OPERATIONS

The Michigan South Central Power Agency (the Agency) is a body politic and corporate, of the State of Michigan organized on March 21, 1978, under the authority of Michigan Public Act 448 of 1976 (the Act), to supply electricity to member municipalities in south central Michigan. The Act provides that the Agency will establish rates and charges so as to produce revenues sufficient to cover costs (excluding depreciation and amortization expense) including debt service, but it may not operate its projects for profit, except insofar as any such profit will inure to the benefit of the public.

The Agency's member municipalities are the Cities of Coldwater, Hillsdale and Marshall and the Village of Clinton and Union City. Each is a municipal corporation, organized under the laws of the State of Michigan, which owns and operates a municipal electric system. The member municipalities presently supply their customers with power and energy generated from the Agency's Project I and from the municipalities' existing generating facilities and also with power purchased from other utility companies. Project I consists of a 55 MW coal fired generation facility and related transmission and substation equipment. Project II consists of a series of diesel fired peaking units capable of producing 16.5 megawatts of power. Project III consists of a series of diesel fired peaking units capable of producing 14.85 megawatts of power. The Agency is currently evaluating the feasibility of relocating units to Project I and member municipality sites. This relocation would provide for increased local generation under blackout conditions. The participants of Project I and Project III are the Cities of Coldwater, Hillsdale and Marshall, the Villages of Clinton and Union City. All members except the Village of Union City are participants in Project II.

Each of the member municipalities entered into (a) a Power Sales Contract with the Agency for the supply of power and energy from the Agency and (b) a Substation Agreement with the Agency for services provided by the Agency to the member municipality with respect to substation facilities; both of these agreements will remain in effect as long as Power Supply System Revenue Refunding Bonds (Revenue Refunding Bonds), 2004, 2002, and 1992 Series and Power Supply System Revenue Bonds 2003 and 2000 Series are outstanding. Each member municipality also entered into an Economic Dispatch Agreement with the Agency providing for the dispatch by the Agency of power and energy from certain existing generating facilities of the member municipalities on an economic basis. The Power Sales Contract between the Agency and the member municipalities require the Agency to provide, and the member municipalities to purchase from the Agency, all of the members' bulk power supply, as defined in the contracts. Each member is obligated to pay its share of the Agency's operating and debt service costs of Project I. The Substation Agreements require the Agency to provide, and the municipalities to purchase, services of the municipalities' substation facilities for transmission, transformation and delivery of electric power and energy from the Agency to the municipalities. Under the Economic Dispatch Agreement, the member municipalities are required to sell to the Agency power generated by their facilities, defined as dedicated capacity.

During the years ended June 30, 2006 and 2005, substantially all sales of power recognized by the Agency were made to its member municipalities.

MICHIGAN SOUTH CENTRAL POWER AGENCY

NOTES TO FINANCIAL STATEMENTS

June 30, 2006 and 2005

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES AND NATURE OF OPERATIONS (cont.)

BASIS OF PRESENTATION

In accordance with Governmental Accounting Standards Board (GASB) No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities that use Proprietary Fund accounting*, the Agency applies all applicable GASB pronouncements as well as all Financial Accounting Standards Board (FASB) Statements and Interpretations, Accounting Principals Board (APB) Opinions, and Accounting Research Bulletins (ARB), unless those pronouncements conflict with or contradict GASB pronouncements.

The Agency's accounts are maintained in accordance with the Uniform System of Accounts of the Federal Energy Regulatory Commission, as required by the Power Sales Contracts with the member municipalities, and in conformity with accounting principles generally accepted in the United States of America. A separate set of plant accounts is maintained for each of the Agency's projects.

USE OF ESTIMATES

Preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reported period. Actual results could differ from those estimates.

CAPITAL ASSETS – UTILITY PLANT

The Agency capitalizes assets with an original cost of \$5,000 or more and a useful life of at least two years. The cost of utility plant includes direct and overhead costs. Interest incurred during construction is reflected in the capitalized value of assets, net of interest earned on the invested proceeds over the same period.

When property subject to depreciation is retired or otherwise disposed of in the normal course of business, its cost, together with the cost of removal less salvage, is charged to accumulated depreciation.

The cost of maintenance, repairs and replacements of minor items of property is charged to maintenance expense. The cost of replacements of property is charged to utility plant accounts.

Utility plant in service is depreciated using the straight-line method over the following useful lives:

	<u>Years</u>
Utility Plant in Service	
Project I (composite) – Endicott Generation Station	30
Project II (composite) – Diesel Fired Peaking Unit	30
Project III (composite) – Diesel Fired Peaking Units	30
Substation plant (composite)	30
Transmission facilities (composite)	55
Administrative and maintenance building	10 – 50
Transportation equipment	3 – 5
Furniture and fixtures	5 – 10

MICHIGAN SOUTH CENTRAL POWER AGENCY

NOTES TO FINANCIAL STATEMENTS June 30, 2006 and 2005

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES AND NATURE OF OPERATIONS (cont.)

CASH EQUIVALENTS

For purposes of the statement of cash flows, cash equivalents include unrestricted checking accounts, savings accounts and institutional liquid assets, with initial maturities less than 90 days.

RESTRICTED AND UNRESTRICTED INVESTMENTS

The Agency follows GASB No. 31, *Accounting and Financial Reporting for Certain Investments and for External Investment Pools*. This standard requires investments to be reported at fair value with gains and losses included in the Statement of Revenues, Expenses and Changes in Net Assets.

INVENTORY

Inventory is stated at average carrying cost and consists of coal, limestone and fuel oil.

DEBT RELATED ITEMS

Bond issuance costs, premiums and discounts are deferred and amortized over the life of the bonds based on the effective interest method, with the exception of the 2002, 2003, and 2004 bond costs which are amortized on a straight line basis. Losses on refundings are amortized on the straight line method effective in fiscal 2003.

DEFERRED COSTS AND CREDITS

The Agency has adopted the provisions of Statement of Financial Accounting Standards (FAS) No. 71, *Accounting for the Effects of Certain Types of Regulation* (FAS No. 71). This accounting standard provides for the deferral of costs and revenues which will be recovered through future rate adjustments.

OPERATING REVENUES

The Agency distinguishes *operating* revenues and expenses from *nonoperating* items. Operating revenues and expenses generally result from providing services and producing and delivering electric service in connection with the Agency's principal ongoing operations. The principal operating revenues of the Agency are charges to members for sales and services. Operating expenses for the Agency include the cost of sales and services, administrative expenses, and depreciation on capital assets. All revenues and expenses not meeting this definition are reported as nonoperating revenues and expenses.

Agency billings are rendered and recorded monthly based on month end metered usage.

MICHIGAN SOUTH CENTRAL POWER AGENCY

NOTES TO FINANCIAL STATEMENTS June 30, 2006 and 2005

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES AND NATURE OF OPERATIONS (cont.)

INTEREST INCOME CREDIT

If approved by the Agency's rate-making body, the Agency may grant to its members a credit for interest income earned from the pool of temporary investments held by the Agency (see Note 6). There were no interest income credits granted to the Agency's members for the years ended June 30, 2006 and 2005.

TAXES

The Agency is exempt from State and Federal income taxes.

COMPENSATED ABSENCES

Under terms of employment, non-union employees are granted twelve sick and personal days per year on January 1st. This time cannot be carried over from year to year and is not paid out at year end. Vacation time does accrue for all employees, and up to one week (Union) on one-half of the annual accrual (non-union) may be carried over at year end. Sick leave and vacation benefits earned but not yet taken have been recorded in the financial statements. Union employees are granted three personal days per year which cannot be carried over from year to year.

NOTE 2 – CASH AND INVESTMENTS

The Agency's Trust Indenture for the Power Supply System Revenue Refunding Bonds (Note 5) authorizes the Agency to deposit funds only in banks insured by the Federal Deposit Insurance Corporation. The Agency may also make investments in U.S. Government and federal Agency obligations, investment grade bonds, commercial paper rated at the highest classification established by at least two standard rating services, money market mutual funds, repurchase agreements, and pooled investment funds. The Agency's internal policy is to not invest funds in repurchase agreements.

Investments are stated at fair value, which is the amount at which an investment could be exchanged in a current transaction between willing parties. Fair values are based on quoted market prices. No investments are reported at amortized cost. Adjustments necessary to record investments at fair value are recorded in the operating statement as increases or decreases in investment income.

Deposits in banks are insured by the FDIC in the amount of \$100,000 for all interest bearing accounts and \$100,000 for all noninterest bearing accounts. The difference between the bank balance and carrying amount is due to outstanding checks, deposits in transit, and/or market value adjustments.

MICHIGAN SOUTH CENTRAL POWER AGENCY

NOTES TO FINANCIAL STATEMENTS

June 30, 2006 and 2005

NOTE 2 – CASH AND INVESTMENTS (cont.)

The CLASS investment (Cooperative Liquid Assets Securities System) is an investment pool established by an intergovernmental agreement dated October 1, 1991. CLASS is available for investment by Michigan governmental entities except school districts. CLASS operates consistent with the provisions of a 2a-7 like pool, and invests only in investments legally permissible under Michigan law, with a weighted average maturity not exceeding 120 days. The value of pool shares is the same as the fair value position in the pool.

CUSTODIAL CREDIT RISK

Deposit

Custodial credit risk is the risk that in the event of a financial institution failure, the Agency's deposits may not be returned to the Agency.

As of June 30, 2006 and 2005, \$89,843 and \$122,188 of the Agency's total bank balances of \$348,332 and \$620,946, respectively, were exposed to custodial credit risk as it was uninsured and uncollateralized.

This Agency's investment policy does not address this risk.

Investment

For an investment, custodial credit risk is the risk that, in the event of the failure of the counterparty, the Agency will not be able to recover the value of its investments or collateral securities that are in the possession of an outside party.

As of June 30, 2006 and 2005, the following investments were exposed to custodial credit risk as neither insured nor registered and held by counterparty's trust department or agent not in the Agency's name:

	<u>2006</u>	<u>2005</u>
External pools	\$ 76,127	\$ 86,405
Mutual funds	<u>6,144,370</u>	<u>6,184,141</u>
Totals	<u>\$ 6,220,497</u>	<u>\$ 6,270,546</u>

This Agency's investment policy specifies that the Agency shall only invest in securities deemed appropriate by the Bond Resolution securing the Agency's debt.

CREDIT RISK

As of June 30, 2006 and 2005, the Agency's investments were rated as follows:

<u>Investment Type</u>	<u>Standard & Poor's</u>
US Agency securities	AAA

MICHIGAN SOUTH CENTRAL POWER AGENCY

NOTES TO FINANCIAL STATEMENTS June 30, 2006 and 2005

NOTE 2 – CASH AND INVESTMENTS (cont.)

CREDIT RISK (cont.)

The Agency also held investments in the following investments which are not rated:

External pool – Comerica
Mutual funds – U.S. Bank
Mutual funds – Fidelity
MI Class

This Agency's investment policy specifies that the Agency shall only invest in securities deemed appropriate by the Bond Resolution securing the Agency's debt.

CONCENTRATION OF CREDIT RISK

At June 30, 2006 and 2005, the investment portfolio was concentrated as follows:

Investment Type	Issuer	Percentage of Portfolio	
		2006	2005
US Government Agency Securities	Federal Farm Credit	21%	9%
	Federal Farm Credit Bank	0%	12%
	Federal Home Loan	0%	5%
	Federal Home Loan Bank	27%	21%
	Federal Home Loan Mortgage	8%	0%
	Federal National Mortgage Association	17%	18%

This Agency's investment policy does not address this risk.

INTEREST RATE RISK

As of June 30, 2006, the Agency's investments were as follows:

Investment Type	Fair Value	Maturity	
		Less than 1 Year	1 – 5 Years
US Government Agency Securities	\$ 22,521,638	\$ 4,640,429	\$ 17,881,209
US Treasuries	984,375	984,375	-
Other external pools	76,127	76,127	-
Mutual funds	6,144,370	6,144,370	-
Totals	<u>\$ 29,726,510</u>	<u>\$ 11,845,301</u>	<u>\$ 17,881,209</u>

MICHIGAN SOUTH CENTRAL POWER AGENCY

NOTES TO FINANCIAL STATEMENTS

June 30, 2006 and 2005

NOTE 2 – CASH AND INVESTMENTS (cont.)

INTEREST RATE RISK (cont.)

As of June 30, 2005, the Agency's investments were as follows:

Investment Type	Fair Value	Maturity	
		Less than 1 Year	1 – 5 Years
US Government			
Agency Securities	\$ 25,631,322	\$ 2,600,801	\$ 23,030,521
Other external pools	120,877	120,877	-
Mutual funds	6,063,264	6,063,264	-
Totals	\$ 31,815,463	\$ 8,784,942	\$ 23,030,521

This Agency's investment policy specifies that the Agency shall seek overall returns that approximate three to five year government interest rates for the current year. Investments greater than five years are not allowed.

NOTE 3 – RESTRICTED AND UNRESTRICTED INVESTMENTS

The Power Supply System Revenue Bond Resolution requires that the payments by the member municipalities for project power be deposited into special funds and that they be used only for operating costs, debt service and other stipulated purposes. The fund's purposes and balances are summarized below.

Fund	Purpose
Operations and Maintenance	To accumulate sufficient funds by the end of each month to pay the subsequent month's expenses.
Bond Service Fund	To accumulate funds to pay the current portion of the bond principal and interest.
Bond Reserve Fund	To reserve funds equal to the maximum annual principal and interest requirements for the outstanding bonds.
Reserve and Contingency Fund	To reserve funds for major renewals and replacements, extraordinary operations and maintenance costs, and any contingencies.

MICHIGAN SOUTH CENTRAL POWER AGENCY

NOTES TO FINANCIAL STATEMENTS June 30, 2006 and 2005

NOTE 3 – RESTRICTED AND UNRESTRICTED INVESTMENTS (cont.)

The following is a summary of investments as of June 30, 2006 and 2005:

	2006	2005
Current Investments		
Restricted		
Bond service fund	\$ 5,609,634	\$ 5,256,332
Bond reserve fund	2,647,992	744,123
Unrestricted	1,139,843	349,303
Total Current Investments	<u>9,397,469</u>	<u>6,349,758</u>
Non-Current Investments		
Restricted		
Bond reserve fund	9,466,425	11,146,691
Reserve and contingency fund	1,090,580	1,090,580
Unrestricted	9,167,392	10,793,416
Total Non-Current Investments	<u>19,724,397</u>	<u>23,030,687</u>
Total Investments	29,121,866	29,380,445
Cash and cash equivalents – unrestricted	<u>1,918,261</u>	<u>6,847,129</u>
Total Cash and Investments	<u>\$ 31,040,127</u>	<u>\$ 36,227,574</u>

NOTE 4 – CHANGES IN CAPITAL ASSETS

A summary of changes in capital assets for 2006 and 2005 follows:

2006

	Balance 7/1/05	Additions/ Reclassi- fications	Deletions/ Reclassi- fications	Balance 6/30/06
Capital assets, not being depreciated				
Land	\$ 1,164,709	\$ 238,810	\$ -	\$ 1,403,519
Construction work in progress	<u>-</u>	<u>202,344</u>	<u>(46,065)</u>	<u>156,279</u>
Total Capital Assets, Not Being Depreciated	<u>1,164,709</u>	<u>441,154</u>	<u>(46,065)</u>	<u>1,559,798</u>
Capital assets being depreciated				
Project I (composite) -				
Generation Station	79,260,077	1,834,667	(145,961)	80,948,783
Project II (composite) -				
Diesel Fired Peaking Unit	5,920,980	-	-	5,920,980
Project III	2,200,000	-	-	2,200,000
General Plant	<u>4,673,086</u>	<u>67,340</u>	<u>(36,979)</u>	<u>4,703,447</u>
Total Capital Assets Being Depreciated	<u>92,054,143</u>	<u>1,902,007</u>	<u>(182,940)</u>	<u>93,773,210</u>
Total Capital Assets	<u>93,218,852</u>	<u>2,343,161</u>	<u>(229,005)</u>	<u>95,333,008</u>

MICHIGAN SOUTH CENTRAL POWER AGENCY

NOTES TO FINANCIAL STATEMENTS June 30, 2006 and 2005

NOTE 4 – CHANGES IN CAPITAL ASSETS (cont.)

2006 (cont.)

	Balance 7/1/05	Additions/ Reclassi- fications	Deletions/ Reclassi- fications	Balance 6/30/06
Less: Accumulated Depreciation				
Project I (composite) -				
Generation Station	\$ 51,316,560	\$ 2,654,545	\$ (138,922)	\$ 53,832,183
Project II (composite) -				
Diesel Fired Peaking Unit	674,306	197,366	-	871,672
Project III	110,000	73,333	-	183,333
General Plant	4,070,572	74,300	(36,002)	4,108,870
Total Accumulated Depreciation	<u>56,171,438</u>	<u>2,999,544</u>	<u>(174,924)</u>	<u>58,996,058</u>
Net Capital Assets	<u>\$ 37,047,414</u>			<u>\$ 36,336,950</u>

2005

	Balance 7/1/04	Additions/ Reclassi- fications	Deletions/ Reclassi- fications	Balance 6/30/05
Capital assets, not being depreciated				
Land	\$ 1,164,709	\$ -	\$ -	\$ 1,164,709
Construction work in progress	83,036	2,463,223	(2,546,259)	-
Total Capital Assets, Not Being Depreciated	<u>1,247,745</u>	<u>2,463,223</u>	<u>(2,546,259)</u>	<u>1,164,709</u>
Capital assets being depreciated				
Project I (composite) -				
Generation Station	77,394,831	2,517,196	(651,950)	79,260,077
Project II (composite) -				
Diesel Fired Peaking Unit	5,920,980	-	-	5,920,980
Project III	2,200,000	-	-	2,200,000
General Plant	4,674,274	29,063	(30,251)	4,673,086
Total Capital Assets Being Depreciated	<u>90,190,085</u>	<u>2,546,259</u>	<u>(682,201)</u>	<u>92,054,143</u>
Total Capital Assets	<u>91,437,830</u>	<u>5,009,482</u>	<u>(3,228,460)</u>	<u>93,218,852</u>
Less: Accumulated Depreciation				
Project I (composite) -				
Generation Station	49,169,652	2,628,388	(481,480)	51,316,560
Project II (composite) -				
Diesel Fired Peaking Unit	476,940	197,366	-	674,306
Project III	36,667	73,333	-	110,000
General Plant	4,012,725	88,098	(30,251)	4,070,572
Total Accumulated Depreciation	<u>53,695,984</u>	<u>2,987,185</u>	<u>(511,731)</u>	<u>56,171,438</u>
Net Capital Assets	<u>\$ 37,741,846</u>			<u>\$ 37,047,414</u>

MICHIGAN SOUTH CENTRAL POWER AGENCY

NOTES TO FINANCIAL STATEMENTS June 30, 2006 and 2005

NOTE 5 – LONG-TERM DEBT

The Agency has issued the following revenue bonds:

<u>Date</u>	<u>Purpose</u>	<u>Final Maturity</u>	<u>Interest Rates</u>	<u>Original Issue</u>
Nov. 1, 1992	Partial refunding of 1986 revenue refunding bonds	Nov. 1, 2006	3.50–5.90%	\$ 52,425,000

The annual debt service requirements of the 1992 bonds to maturity are as follows:

<u>Year</u>	<u>Principal</u>	<u>Interest</u>	<u>Total</u>
2006	<u>\$ 7,485,000</u>	<u>\$ 441,615</u>	<u>\$ 7,926,615</u>

<u>Date</u>	<u>Purpose</u>	<u>Final Maturity</u>	<u>Interest Rate</u>	<u>Original Issue</u>
Dec 28, 2000	Project II	May 1, 2012	6.00%	\$ 6,475,000

The annual bond service requirements of the 2000 bonds to maturity are as follows:

<u>Year</u>	<u>Principal</u>	<u>Interest</u>	<u>Total</u>
2006	\$ -	\$ 360,000	\$ 360,000
2007	-	360,000	360,000
2008	-	360,000	360,000
2009	-	360,000	360,000
2010	990,000	360,000	1,350,000
2011	1,095,000	329,100	1,424,100
2012	<u>3,915,000</u>	<u>234,900</u>	<u>4,149,900</u>
Totals	<u>\$ 6,000,000</u>	<u>\$ 2,364,000</u>	<u>\$ 8,364,000</u>

MICHIGAN SOUTH CENTRAL POWER AGENCY

NOTES TO FINANCIAL STATEMENTS June 30, 2006 and 2005

NOTE 5 – LONG-TERM DEBT (cont.)

<u>Date</u>	<u>Purpose</u>	<u>Final Maturity</u>	<u>Interest Rate</u>	<u>Original Issue</u>
Nov 21, 2002	Refunding of 1991 and 1986 revenue refunding bonds	Nov 1, 2011	5.00%	\$ 31,190,000

The annual bond service requirements of the 2002 bonds to maturity are as follows:

<u>Year</u>	<u>Principal</u>	<u>Interest</u>	<u>Total</u>
2006	\$ -	\$ 1,559,500	\$ 1,559,500
2007	-	1,559,500	1,559,500
2008	7,535,000	1,371,125	8,906,125
2009	7,895,000	985,375	8,880,375
2010	8,290,000	580,750	8,870,750
2011	7,470,000	186,750	7,656,750
Totals	<u>\$ 31,190,000</u>	<u>\$ 6,243,000</u>	<u>\$ 37,433,000</u>

<u>Date</u>	<u>Purpose</u>	<u>Final Maturity</u>	<u>Interest Rate</u>	<u>Original Issue</u>
Sept 3, 2003	Project III	Nov 1, 2010	4.08%	\$ 2,220,000

The annual bond service requirements of the 2003 bonds to maturity are as follows:

<u>Year</u>	<u>Principal</u>	<u>Interest</u>	<u>Total</u>
2006	\$ 308,783	\$ 55,828	\$ 364,611
2007	321,100	43,510	364,610
2008	333,909	30,701	364,610
2009	347,229	17,382	364,611
2010	178,776	3,531	182,307
Totals	<u>\$ 1,489,797</u>	<u>\$ 150,952</u>	<u>\$ 1,640,749</u>

MICHIGAN SOUTH CENTRAL POWER AGENCY

NOTES TO FINANCIAL STATEMENTS June 30, 2006 and 2005

NOTE 5 – LONG-TERM DEBT (cont.)

Date	Purpose	Final Maturity	Interest Rate	Original Issue
Oct.21, 2004	Refunding of 1994 revenue Refunding bond	Nov 1, 2011	Variable	\$ 9,200,000

The 2004 bonds are at a variable interest rate which adjusts monthly. As such, an exact repayment schedule is unknown. The following was prepared using the 3.375% interest rate recommended by the agency's financial advisor. The estimated annual bond service requirements of the 2004 bonds to maturity are as follows:

Year	Principal	Interest	Total
2006	\$ -	\$ 310,500	\$ 310,500
2007	220,000	310,500	530,500
2008	275,000	303,075	578,075
2009	175,000	293,794	468,794
2010	225,000	287,888	512,888
2011	8,305,000	280,294	8,585,294
Totals	<u>\$ 9,200,000</u>	<u>\$ 1,786,051</u>	<u>\$ 10,986,051</u>

Long-term debt activity for the year ended June 30, 2006 and 2005 is as follows:

	6/30/05 Balance	Additions	Reductions	6/30/06 Balance	Due Within One Year
Revenue bonds	\$ 62,631,735	\$ -	\$ 7,266,938	\$ 55,364,797	<u>\$ 7,793,783</u>
Discounts/Premiums	1,295,725	-	228,273	1,067,448	
Loss on refunding	<u>(2,759,212)</u>	-	916,124	<u>(1,843,088)</u>	
Net Bonds	<u>\$ 61,168,248</u>			<u>\$ 54,589,157</u>	

	6/30/04 Balance	Additions	Reductions	6/30/05 Balance	Due Within One Year
Revenue bonds	\$ 69,727,283	\$ 9,200,000	\$ 16,295,548	\$ 62,631,735	<u>\$ 7,266,938</u>
Discounts/Premiums	1,363,570	-	67,845	1,295,725	
Loss on refunding	<u>(3,295,544)</u>	2,429,707	2,966,039	<u>(2,759,212)</u>	
Net Bonds	<u>\$ 67,795,309</u>			<u>\$ 61,168,248</u>	

MICHIGAN SOUTH CENTRAL POWER AGENCY

NOTES TO FINANCIAL STATEMENTS June 30, 2006 and 2005

NOTE 5 – LONG TERM DEBT (cont.)

ADVANCE REFUNDING

In October of 2004, the Agency issued \$9,200,000 in bonds with variable interest rate to refund \$8,385,000 of outstanding 1994 bonds with an average interest rate of 7.0 percent. In addition the Agency completed a partial defeasance of \$345,000 of the 1992 bonds and \$475,000 of the 2000 bonds. The net proceeds of \$8,790,088 (after payment of \$409,912 in underwriting fees, insurance and other issuance costs) plus an additional \$1,035,144 of sinking fund monies were used to purchase U.S. government securities. Those securities were deposits in irrevocable trusts with an escrow agent to provide for all future debt service payments on the old bonds. As a result, the old bonds are considered to be defeased and the liabilities for the old bonds have been removed from the balance sheet.

The cash flow requirements for debt service prior to the refundings were \$81,837,634 from 2005 through 2012. The cash flow requirements for debt service after refundings are estimated at \$79,571,564 from 2005 through 2012. As the 2004 bonds are variable interest rate debt the exact debt service is not known at this time. This estimate was provided by the Agency's financial advisor using an interest rate of 3.375% over the life of the bonds. The advance refunding resulted in an estimated economic gain of \$929,556.

NOTE 6 – NET DEFERRED COSTS RECOVERABLE IN FUTURE YEARS

Deferred costs recoverable in future years consist of costs incurred by the Agency which were not billed to the member municipalities during the period in which they were incurred.

These amounts have historically been composed of depreciation and amortization expense (noncash expenditures which under the Power Sales Contracts cannot be billed to the member municipalities) in excess of the principal repayments on related debt. During fiscal 2006, these accumulated deferred costs were completely recovered.

Certain other costs incurred during fiscal 2005 and 2006 were deferred until the appropriate allocation between members can be determined.

GAAP requires that these items be removed from the statement of net revenues and expenses and accumulated equity, and recorded as an asset or liability in the year in which they were incurred. These items are then recognized in future years when the item is included in allowable costs for rate-making purposes.

MICHIGAN SOUTH CENTRAL POWER AGENCY

NOTES TO FINANCIAL STATEMENTS June 30, 2006 and 2005

NOTE 6 – NET DEFERRED COSTS RECOVERABLE IN FUTURE YEARS (cont.)

The components of the deferred costs recoverable in future years as of June 30, 2006 and 2005 are as follows:

	<u>2006</u>	<u>2005</u>
Deferred costs recoverable in future periods:		
Cost to be billed once allocable	\$ 762,324	\$ 335,143
Total Deferred Costs Recoverable in Future Periods	<u>\$ 762,324</u>	<u>\$ 335,143</u>

The change in the components of deferred costs recoverable in future years for the years ended June 30, 2006 and 2005, are as follows:

	<u>2006</u>	<u>2005</u>
Depreciation and amortization less than debt service principal payments	\$ -	\$ (1,213,440)
Decrease in Deferred Costs Per Income Statement	-	(1,213,440)
Seams Elimination Cost Adjustment (SECA)	(243,178)	243,178
Baseload Feasibility study	119,253	60,655
Metering project	51,106	31,310
MISO RSG	500,000	-
Net Increase (Decrease) in Deferred Costs	<u>427,181</u>	<u>(878,297)</u>
Balance at Beginning of Year	<u>335,143</u>	<u>1,213,440</u>
Balance at End of Year	<u>\$ 762,324</u>	<u>\$ 335,143</u>

Additionally, in 2001, the Agency's Board approved the deferral of approximately \$3,200,000 in maintenance costs incurred for the overhaul of the turbine generator. Such costs will be recognized as a component of maintenance expense. For fiscal years 2005 and 2006 \$300,000 per year was recognized.

MICHIGAN SOUTH CENTRAL POWER AGENCY

NOTES TO FINANCIAL STATEMENTS June 30, 2006 and 2005

NOTE 7 – DEFERRED RATE STABILIZATION

Effective in September 1994, management of the Agency implemented a plan to provide its members with refunds utilizing assets of a rate stabilization equity fund then held by the Agency.

Effective in August 1996, management of Agency implemented a new plan to provide a rate relief in future periods to the Agency's members utilizing advance contributions of the members.

Deposits, net of withdrawals, previously included in equity were reclassified in 2003.

The equity fund, which then totaled approximately \$3,000,000 consisted of member contributions aggregating approximately \$1,200,000 and interest thereon totaling approximately \$1,800,000, and was originally established in 1986 to provide rate relief in future periods to the Agency's members. The Agency anticipates that the remaining undistributed member contributions of \$1,000,000 and undistributed interest earned on the equity fund of \$1,200,000 will be distributed to its members in an indeterminable period in the future out of currently available unrestricted accumulated equity.

As of June 30, 2006 and 2005, the Agency had received cumulative contributions totaling \$7,184,984 and \$7,154,253, respectively, and provided cumulative distributions to its members totaling \$8,871,533 and \$5,319,674, respectively. Interest accrued on these funds of \$2,810,517 at June 30, 2005 was included in the fund equity. As of July 1, 2005, the undistributed accrued interest of \$2,369,352 was removed from equity and added to the liability as the result of a change in accounting principle. See Note 16 for more details.

The Agency anticipates the member contributions will be distributed to its members in an indeterminable period in the future out of currently available unrestricted funds. Accordingly, at June 30, 2006 and 2005, the Agency has established a liability of \$1,226,793 and \$2,278,306, respectively, for Deferred Rate Stabilization.

MICHIGAN SOUTH CENTRAL POWER AGENCY

NOTES TO FINANCIAL STATEMENTS June 30, 2006 and 2005

NOTE 8 – NET ASSETS

GASB No. 34 requires the classification of net assets into three components – invested in capital assets, net of related debt; restricted; and unrestricted. These classifications are defined as follows:

Invested in capital assets, net of related debt – This component of net assets consists of capital assets, including restricted capital assets, net of accumulated depreciation and reduced by the outstanding balances of any bonds, mortgages, notes, or other borrowings that are attributable to the acquisition, construction, or improvement of those assets. If there are significant unspent related debt proceeds at year-end, the portion of the debt attributable to the unspent proceeds are not included in the calculation of invested in capital assets, net of related debt. Rather, that portion of the debt is included in the same net assets component as the unspent proceeds.

Restricted – This component of net assets consists of constraints placed on net asset use through external constraints imposed by creditors (such as through debt covenants), grantors, contributors, or laws or regulations of other governments or constraints imposed by law through constitutional provisions or enabling legislation.

Unrestricted net assets – The component of net asset consist of net assets that do not meet the definition of “restricted” or “invested in capital assets, net of related debt.”

When both restricted and unrestricted resources are available for use, it is the utilities’ policy to use restricted resources first, then unrestricted resources as they are needed.

The following calculation supports the net assets invested in capital assets, net of related debt:

	6/30/06	6/30/05
Capital Assets		
Utility plant in service and work in progress	\$ 95,333,008	\$ 93,218,852
Allowance for depreciation	(58,996,058)	(56,171,438)
Related Debt		
Revenue bonds payable, less current portion (includes discounts, premiums and losses)	(46,795,374)	(53,901,310)
Current portion of revenue bonds	(7,793,783)	(7,266,938)
Deferred bond issue costs – net	1,340,730	1,646,321
Invested in Capital Assets, Net of Related Debt	<u>\$ (16,911,477)</u>	<u>\$ (22,474,513)</u>
Restricted Net Assets		
Restricted assets		
Bond service fund	\$ 5,609,634	\$ 5,256,332
Bond reserve fund – current	2,647,992	744,123
Reserve and contingency fund – current	-	-
Bond reserve fund – noncurrent	9,466,425	11,146,691
Reserve and contingency fund – noncurrent	1,090,580	1,090,580
Current liabilities payable from restricted assets		
Accrued interest payable	(432,974)	(491,084)
Restricted Net Assets	<u>\$ 18,381,657</u>	<u>\$ 17,746,642</u>

MICHIGAN SOUTH CENTRAL POWER AGENCY

NOTES TO FINANCIAL STATEMENTS June 30, 2006 and 2005

NOTE 9 – EMPLOYEE RETIREMENT PLAN

The Agency contributes to the Municipal Employees Retirement System of Michigan (MERS), an agent defined benefit multiple-employer public employee retirement system that acts as a common investment and administrative agent for municipalities. The Agency's defined benefit pension plan provides retirement and disability benefits to covered employees and beneficiaries. The present benefit provisions of MERS are governed by Act No. 220 of the Public Acts of 1996, as amended and the MERS Plan Document as revised. The MERS issues a publicly available financial report that includes financial statements and required supplementary information. That report may be obtained by writing to Municipal Employees Retirement System of Michigan, 447 N. Canal Road, Lansing, Michigan 48917.

The Agency funds the entire cost of each employee's participation in MERS. Contribution requirements of employees and the Agency are established and may be amended by the MERS Board of Trustees.

For 2006, 2005, and 2004, the Agency's annual pension cost of \$284,664, \$279,960, and \$256,572, respectively, for the MERS was equal to the Agency's required and actual contributions.

The 2006 required contribution was determined as part of the December 31, 2005 actuarial valuation using the entry age normal cost method. This method seeks to provide a level pattern of cost as a percentage of salary throughout an employee's working lifetime. The actuarial assumptions included: (a) 8.0% investment rate of return in 2006, 2005, and 2004; (b) projected salary increases of 4.5% in 2006, 2005, and 2004; and (c) additional projected salary increases ranging from 0% to 4.16% in 2006, 2005, and 2004 depending on age, attributable to seniority and merit.

Schedule of Funding Progress (Unaudited – Required Information)

<u>Valuation Date</u>	<u>Actuarial Asset Values</u>	<u>Actuarial Accrued Liability (AAL)</u>	<u>Unfunded AAL (UAAL)</u>	<u>Funded Ratio</u>	<u>Covered Payroll</u>	<u>UAAL as a Percentage of Covered Payroll</u>
December 31, 2002	\$ 4,100,623	\$ 5,542,082	\$ 1,441,459	74.0%	\$ 2,298,839	62.7%
December 31, 2003	4,606,439	6,276,942	1,670,503	73.4	2,562,793	65.2
December 31, 2004	5,081,085	6,976,587	1,895,502	72.8	2,621,348	72.3
December 31, 2005	5,562,479	7,527,441	1,964,962	73.9	2,634,274	74.6

MICHIGAN SOUTH CENTRAL POWER AGENCY

NOTES TO FINANCIAL STATEMENTS

June 30, 2006 and 2005

NOTE 10 – LEASES

The Agency entered into an operating lease agreement for rental of certain equipment, which commenced in April 2001. The lease agreement requires monthly rental payments of \$29,789 through 2007. Future minimum lease payments are as follows:

2006	\$ 357,468
2007	<u>268,101</u>
Total	<u>\$ 625,569</u>

In August 2006, the Agency entered into an agreement to purchase this equipment and terminate the remaining lease.

NOTE 11 – LONG-TERM SUPPLY AGREEMENTS

On December 12, 2001, the Agency entered into a fixed-price contract for the continuous supply of 30 MWH of power with CMS Energy. This contract was sold to Constellation Power Services on March 27, 2003. The exact rates and terms of the agreement are subject to a confidentiality agreement.

On June 14, 2004, the Agency entered into a fixed-price Master Services Agreement with American Municipal Power–Ohio, Inc. (AMP–Ohio) for power supply and hourly load energy services. The term for this agreement was one year with a one year extension option. At this time, all Agency members have become members of AMP–Ohio and these services are provided by AMP–Ohio to the Agency on behalf of the mutual members.

NOTE 12 – MARKET PARTICIPATION

The Agency began participating in the Midwest Independent System Operator (MISO) energy market on April 1, 2005. MISO invoices the Agency for net generation sales or power purchases. These invoices are subject to future true-ups based on improved data. True-ups typically occur 55 and 105 days after the actual date of service. At year end the Agency is unable to estimate the amount of future adjustments relating to periods prior to year end.

NOTE 13 – RISK MANAGEMENT

The Agency is exposed to various risks of loss related to torts, theft of, damage to, or destruction of assets, errors and omissions, workers compensation, and health care of its employees. These risks are covered through the purchase of commercial insurance with minimal deductibles. Settled claims have not exceeded the commercial liability in any of the past three years.

MICHIGAN SOUTH CENTRAL POWER AGENCY

NOTES TO FINANCIAL STATEMENTS June 30, 2006 and 2005

NOTE 14 – COMMITMENTS

The Agency has entered into contracts related to work to be commenced and completed subsequent to year end. Any service provided as of June 30, 2006 has been accrued in these financial statements.

NOTE 15 – AGGREGATE BOND SERVICE COVERAGE

June 30, 2006

NET REVENUES

Operating Revenues		\$ 44,961,391
Less: Operating Expenses		
Operations	\$ 29,747,444	
Maintenance	2,480,632	
Administration and General	<u>2,047,997</u>	
Total		(34,276,073)
Plus:		
Interest and Miscellaneous Income		<u>1,180,754</u>
TOTAL NET REVENUES, AS DEFINED		<u><u>\$ 11,866,072</u></u>
AGGREGATE BOND SERVICE, AS DEFINED (1)		<u><u>\$ 10,444,962</u></u>
COVERAGE OF AGGREGATE BOND SERVICE BY NET REVENUES		<u><u>1.14</u></u>

June 30, 2005

NET REVENUES

Operating Revenues		\$ 38,634,773
Less: Operating Expenses		
Operations	\$ 23,961,927	
Maintenance	2,117,944	
Administration and General	<u>1,901,185</u>	
Total		(27,981,056)
Plus:		
Interest and Miscellaneous Income		<u>1,107,040</u>
TOTAL NET REVENUES, AS DEFINED		<u><u>\$ 11,760,757</u></u>
AGGREGATE BOND SERVICE, AS DEFINED (1)		<u><u>\$ 10,544,397</u></u>
COVERAGE OF AGGREGATE BOND SERVICE BY NET REVENUES		<u><u>1.12</u></u>

MICHIGAN SOUTH CENTRAL POWER AGENCY

NOTES TO FINANCIAL STATEMENTS June 30, 2006 and 2005

NOTE 15 – AGGREGATE BOND SERVICE COVERAGE (cont.)

(1) AGGREGATE BOND SERVICE, AS DEFINED

<u>Bond Service:</u>	<u>Total for Fiscal Year Ended</u>	
	<u>June 30, 2006</u>	<u>June 30, 2005</u>
1992 Series	\$ 7,889,702	\$ 7,886,814
1994 Series	-	244,563
2000 Series	355,250	355,250
2002 Series	1,559,500	1,559,500
2003 Series	364,611	364,611
2004 Series	275,899	133,659
Aggregate Bond Service	<u>\$ 10,444,962</u>	<u>\$ 10,544,397</u>

1. Section 6.13 of the Power Supply System Revenue Bond Resolution (the Resolution) dated August 23, 1979, as amended, for each Series of Construction Bonds requires – The Agency will, at all times while any of the bonds are Outstanding, establish, fix, prescribe and collect rates and charges for the sale or use of electric power and energy or related services produced, transmitted, distributed or furnished by the System which, together with other income, are reasonably expected to yield (a) for the forthcoming twelve-month period, Net Revenues equal to at least 1.10 times the Aggregate Bond Service for that period and, (b) at all times, Revenues at least equal to the amounts of all deposits required by the terms of the Resolution to be made into the funds and accounts held under the Resolution and not otherwise provided for. Promptly upon any material change in the circumstances which were contemplated at the time the rates and charges were most recently reviewed, but not less frequently than once in each Fiscal Year, the Agency shall review the rates and charges for electric power and energy and related services and shall promptly revise the rates and charges as necessary to comply with the foregoing requirement so that the rates and charges shall produce moneys sufficient to enable the Agency to comply with all its covenants under the Resolution.

To comply with the requirements of the above Section of the Resolution, the Michigan South Central Power Agency (the Agency) has prepared the Aggregate Bond Service Coverage Calculation for the twelve months ended June 30, 2006.

2. Definitions of the following terms included in the calculation discussed in Note 1 are as indicated in Article I Section 1.01 Definitions of the Resolution:

Net Revenues
Revenues
Operations and Maintenance Costs
Aggregate Bond Service
Bond Service

All references to Generally Accepted Accounting Principles in the above definitions are generally those currently in existence, except for those that are inconsistent with the Resolution, in which case the terms of the Resolution control.

MICHIGAN SOUTH CENTRAL POWER AGENCY

NOTES TO FINANCIAL STATEMENTS June 30, 2006 and 2005

NOTE 16 – CHANGE IN ACCOUNTING PRINCIPLE

As of July 1, 2005, the Agency re-evaluated its treatment of accrued interest on member deferred rate stabilization balances. Historically, these earnings had been recognized as agency income in the period received as the intent was for members to apply them towards Agency projects, rather than transferring cash. In re-examining the policy and this treatment, it was determined that the members have the right to withdraw the accrued interest at any time, for local or Agency projects. It was, therefore, determined that treatment as a liability rather than earned income was more appropriate. The cumulative effect of this change, as of July 1, 2005 of \$2,369,352, has been shown in the current period.

In addition, the \$100,264 of interest accrued during the year ended June 30, 2006 has been recorded as a liability rather than interest income.